

INDIRECT COSTS

SNA

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Overview

- Section 307(a) of The Healthy, Hunger Free Kids Act of 2010 (the Act), Public Law 111-296, requires FNS to provide guidance on program rules pertaining to indirect costs in the NSLP and SBP (*collectively referred to as the SMPs in the indirect cost guidance and this presentation*)
- This presentation will provide a general overview on the indirect cost guidance issued by FNS on July 8, 2011

Why is understanding indirect costs and applying them correctly important?

- To safeguard the limited funds of the nonprofit school food service account!
- The funds in the nonprofit school food service account must only be used to pay for expenses that are necessary and reasonable to provide quality meals in the SMPs



Indirect Costs in a Reimbursement Program

Overview

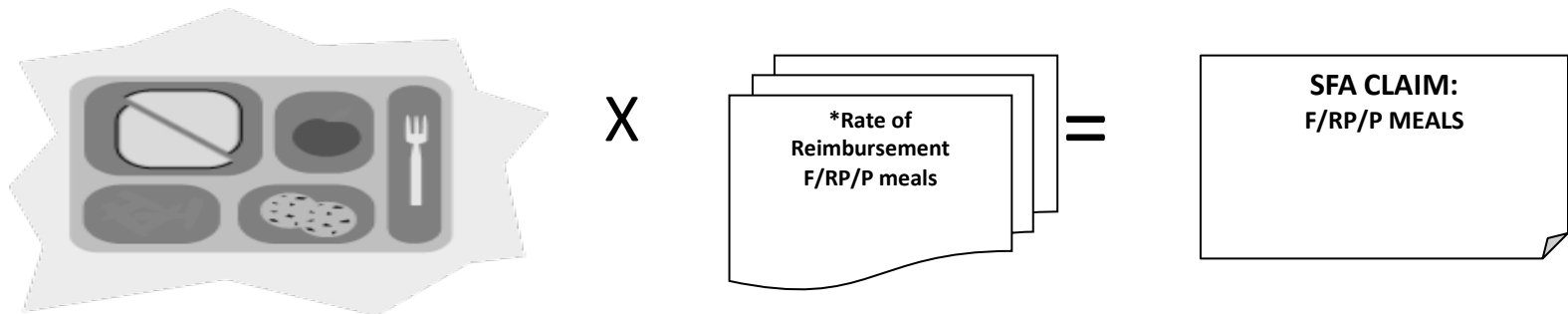
- Before we discuss direct and indirect costs, it will be helpful to briefly summarize how reimbursement works in the SMPs
- This section will provide information on how the SFA is reimbursed monies for providing meals to enrolled students in the SMPs (i.e., buying food, preparing meals, serving meals, etc.)

Other programs

- In many other programs, program operators bill the Federal awarding agency for program costs for reimbursement
- In the SMPs, SFAs do not bill USDA/FNS for the reimbursement of program costs

SMPs

- Subgrantee SFAs report the number of paid, reduced-price, and free meals served (not program costs) to their SAs
- To be reimbursable under the SMPs, each meal served must meet all the requirements set by program regulation



What does this mean?

- SFAs receive certain monies (rate of reimbursement) for each meal served
- This is not free money, there are **strings attached**:
 - ▣ Meals must conform to program regulations
 - ▣ SA and SFA must adhere to Department-wide and program-specific regulations (i.e., Federal cost principles, procurement regulations, etc.)

Nonprofit School Food Service Account

- One of the major responsibilities that accompany the decision to participate in the SMPs is the management of the nonprofit school food service account, which requires those limited funds to be spent solely on the SMPs
- This account must contain all reimbursements and other revenues from all food service operations conducted by the SFA, principally for the benefit of school children, and used **only** for the operation or improvement of the nonprofit school food service



General Overview of Direct & Indirect Costs

Complementary costs

- Total program costs generally include direct and indirect costs

$$\text{Total Program Cost} = \text{Direct Cost} + \text{Indirect Cost}$$

- This is why direct costs must be included when discussing indirect costs

Direct costs

- Direct costs are incurred specifically for a program or other cost objective, and can be readily identified to a particular objective such as school food service
- Examples of direct costs in SMPs include:
 - ▣ Food,
 - ▣ Wages and salaries of the staff working in the school food service,
 - ▣ Supplies specifically used in the school food service

Direct Costs, contd.

- 2 CFR Part 225 describes direct costs as, “those that can be identified specifically with a particular final cost objective”
- Costs that cannot be exclusively attributable to the SMPs should generally be treated as indirect costs

Direct Costs, contd.

- A good question to help understand “identified specifically” is -- Who benefitted from the SFA having incurred the cost (i.e., just school food service)?
- Appendix B of 2 CFR Part 225 provides examples of typical direct costs chargeable to the nonprofit school food service account

Indirect Costs

- Indirect costs are incurred for the benefit of multiple programs, functions, or other cost objectives and therefore cannot be identified readily and specifically with a particular program or other cost objective
- They typically support administrative overhead functions:
 - ▣ Fringe benefits,
 - ▣ Accounting,
 - ▣ Payroll,
 - ▣ Purchasing,
 - ▣ Facilities management,
 - ▣ Utilities, etc

Indirect Costs, contd.

- 2 CFR Part 225 describes indirect costs as those:
“(a) incurred for a common or joint purpose benefiting more than one cost objective, and (b) not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved”
- Costs that can be allocated to multiple programs or other cost objectives are always an indirect cost

Examples of typical costs

Direct Costs	Indirect Costs
Wages and salaries of food service workers	Payroll services
Cost of purchased food	Human resources
Food service supplies	Workers' compensation
Media/promotional materials relating to the food service	Procurement
Capital expenditures relating to food service (e.g., food service equipment purchases)	Gas
	Electricity
	Sewer
	Water
	Trash
	Superintendent's Office

How are indirect costs assigned?

- Allocation -- mathematical exercise used to assign indirect costs to particular programs and other cost objectives, such that each program or other cost objective bears a portion of the indirect costs that is commensurate with the benefit received from such costs
- What does this mean?

How are indirect costs assigned, contd.

- Allocation is a method to assign to school food service their fair share of indirect costs (i.e., portion of utility bills in kitchen and cafeteria)
- This methodology normally entails applying a **calculated indirect cost rate** to a **direct cost base** (**more on this later**)

Remember...

- Many times, cost can be treated either way – direct or indirect
- SFA makes this determination by following the accounting and reporting principles of the State education agency (SEA) which is in accordance with the Federal cost principles (**more on this later**)
 - Depends on how a cost is treated in the SFA's accounting system (**also, more on this later**)



Federal Cost Principles Apply to Indirect Costs

What are the Federal cost principles?

- Government-wide principles for determining allowable costs under contracts, grants, and other agreements with the various entities that operate Federal programs
 - ▣ 2 CFR Part 225 (OMB Circular A-87) applies to State, local, or Indian Tribal governments
 - ▣ 2 CFR Part 230 (OMB Circular A-122) applies to nonprofits

Why are they important?

- In order to be chargeable (i.e., billable) to a Federal program, a cost (whether a direct or indirect cost) must be allowable
- SFA can only bill allowable costs to the nonprofit school food service account!
- The OMB guidance provides general definitions regarding the applicability and allowability of different types of costs

Why are they important, contd.

- They also describe the different allocation methodologies that can be used by the school district and the general criteria for charging or billing costs as direct or indirect

Charge It!

- A simple way of understanding Federal cost principles...



- Picture It: Nonprofit school food service account is a school's bank account. School has a debit card for this account. School can only charge goods and services on this debit card if certain rules are followed (the Federal cost principles)

Structure of 2 CFR 225 (A-87)

- Appendix A provides a list of criteria for allowable costs (more general in nature)
- Appendix B classifies certain costs in three categories:
 - ▣ allowable,
 - ▣ allowable with prior SA approval, or
 - ▣ unallowable

What does this mean?

- Appendix B must be read in conjunction with Appendix A in order to determine whether a cost is allowable

Reading Appendix B with Appendix A

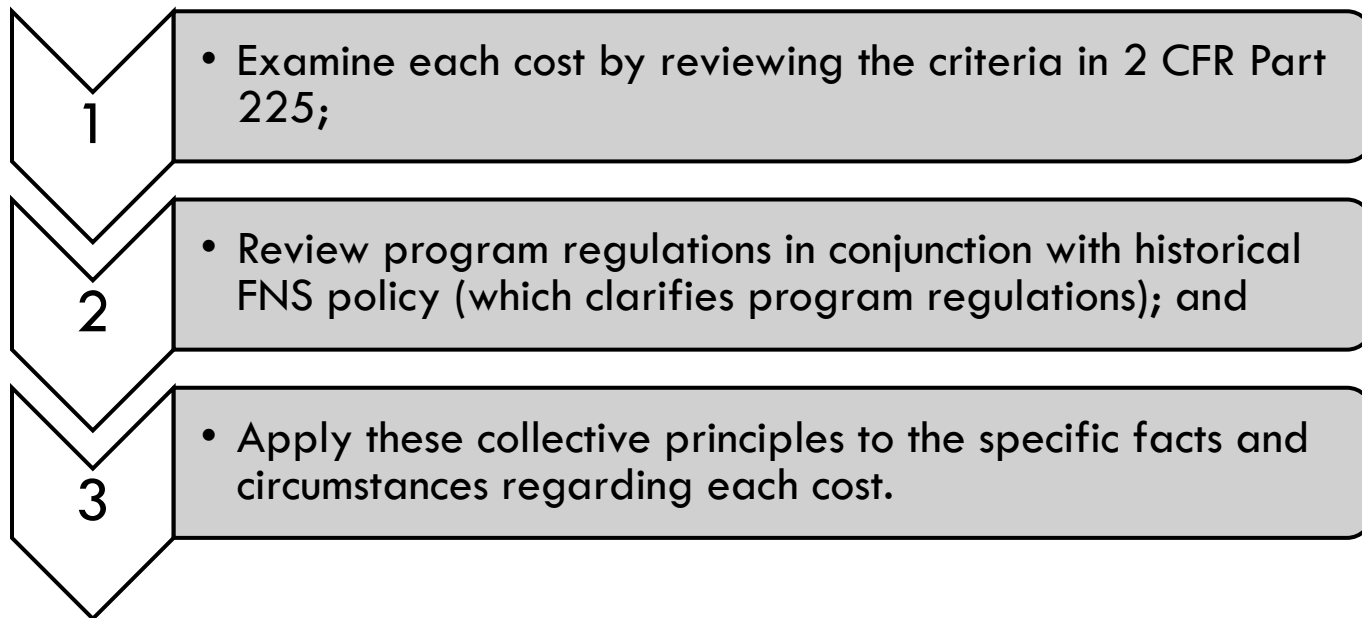
- Appendix B conveys two key points:
 - ▣ Even if Appendix B of 2 CFR Part 225 classifies a cost as allowable, that cost item must still satisfy the Appendix A criteria and conform to any program-specific limitations in order to be allowable

Reading Appendix B with Appendix A, contd.

- ▣ Appendix B's silence regarding a cost item does not mean that a cost item is either allowable or unallowable (remember, Appendix B doesn't mention every type of cost). The SFA must make such determinations by studying Appendix B's treatment of similar or related cost items
- ▣ Next, let's discuss the general criteria in Appendix A to 2 CRF Part 225

Multi-step process

- SFAs follow a multi-step process to determine whether funds from the nonprofit school food service account may be used for a certain cost



General criteria for allowable costs?

- ❑ Necessary;
- ❑ Reasonable;
- ❑ Allocable;
- ❑ Legal under State and local law;
- ❑ Conforms with Federal law, regulation, and grant terms;
- ❑ Consistently treated as direct or indirect;
- ❑ Determined in accordance with Generally Accepted Accounting Principles (GAAP);
- ❑ Not included as a cost or matching contribution of any other grant (except where allowed by Federal regulations);
- ❑ Net of applicable credits; and,
- ❑ Adequately documented

Necessary?

- A cost is **necessary** if the SMPs' authorizing statutory provisions, resulting program regulations or applicable FNS policy establish that the nonprofit school food service cannot be operated without incurring the cost
- ★ e.g., a school food service cannot be operated without incurring the cost of appropriate food

Reasonable?

- A cost is **reasonable** if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost
- ▣ The prudent person standard requires each person to behave as a reasonable person would under the same or similar circumstances

Criteria to help determine necessary & reasonable costs?

- What are the particular objectives of the SMPs?
- How does the cost contribute to achieving an objective of the SMPs?
- Is the cost recognized as ordinary and necessary for the operation of the SMPs?
- Could the SMPs be carried out without incurring this cost?
- Would a prudent person find the cost to be reasonable under the circumstances?

Criteria, contd.

- Would a taxpayer deem the cost to be reasonable in light of SMPs objectives?
- Is this cost charged at a fair rate, or do alternatives exist that may be more cost effective?
- Does the cost deviate significantly from the established practices of the SFA which may unjustifiably increase costs borne by the nonprofit school food service account?
- Could the SFA defend this purchase to the SA, the media, auditors, etc.?

Allocable?

- A cost must be assigned to the program(s), function(s), activity(ies) or other cost objective(s) that benefited from the school district having incurred that cost
- Each cost objective, program, etc. must be charged its fair share of the cost (*cost allocation is the process of achieving this*)

Allocable, contd.

□ Example:

- The salary of an employee whose duties consist solely of preparing and serving school meals is 100-percent allocable to the SFA's school food service, and is therefore treated as a direct cost
- By contrast, the superintendent's salary benefits all programs, functions, and activities of the school district; the portion that benefits the school food service can be determined only through a mathematical allocation process which is the reason it is an indirect cost

Allocable, contd.

- **A cost allocable to a particular Federal award or other cost objective may not be charged (i.e., billed) to other Federal awards to overcome fund deficiencies, to avoid restrictions imposed by regulations or terms of the Federal awards, or for other reasons**
 - In simpler terms, school food service can't be billed a higher share of utility costs just because the school district doesn't have the funds
 - Because such action would assign the cost to a cost objective that did not benefit from it

Treated consistently?

- An SFA must conduct transactions using Federal program funds in the same way that it conducts transactions with its own non-Federal funds
- A cost item must be treated consistently as direct or indirect in all activities of the SFA **unless** legislation, regulations, or guidance from an awarding agency dictates otherwise

Treated consistently, contd.

- A cost may not be assigned to a Federal award as a direct cost if that same cost, incurred for the same purpose, in similar circumstances, has been allocated to other Federal awards as an indirect cost

Treated consistently, contd.

□ Example #1:

- School district requires its custodians to record the time spent cleaning only 2 categories: “Kitchen & Cafeteria” and “Other” (i.e., “Other” is the rest of the school except the kitchen & cafeteria)
 - Custodial expenses recorded under “Kitchen & Cafeteria” is billed to the school food service as a direct cost
 - Custodial expenses recorded under “Other” category is billed as an indirect cost to all of the other departments within the SFA
- This would be considered inconsistent treatment of the cost of custodial services because only school food service is charged directly

Treated consistently, contd.

□ Example #2:

- School food service staff conducts particular functions, such as procurement, that are also conducted by the SFA for other departments:
 - Food service staff conducts direct procurement for food products (treated as direct cost)
 - SFA staff conducts procurement for paper products for all departments including school food service (treated as indirect cost)
- SFA bills the school food service for the cost of procurement services, for paper products **only**, as an indirect cost

Treated consistently, contd.

□ Example #2(contd.):

- There is no inconsistent treatment in this case because the school food service receives an additional benefit!

- What does this mean?
 - There is no inconsistent treatment in this case because the school food service is charged directly for the procurement of food products (this benefits only school food service) and indirectly for the procurement of paper products (this benefits school food service and all other departments within the school district)



Developing & Applying Indirect Cost Rate

“SFA” vs. “LEA”

- We will be using both the terms SFA & LEA
- SMPs regulations define SFA as the governing body responsible for administering one or more schools and with the legal authority to operate the SMPs
- The Child Nutrition and WIC Reauthorization Act of 2004, used the term LEA -- a term commonly used by the U.S. Department of Education when referring to a school district and its operation of Federal education programs, in amendments to some SMPs statutory authorities
 - ▣ LEA is usually used when discussing direct certification and verification

The Problem

- A school district or LEA participates in many Federal programs (not just the SMPs) and needs to allocate indirect costs to all of these programs!

The Solution

- Federal cost principles provide a uniform method of allocating shared costs to grants from each of its Federal awarding agencies
- A single Federal agency, referred to as the **cognizant agency**, speaks for all the Federal awarding agencies in negotiating across-the-board allocation methodology with the program operator

Cognizant agency is the SEA

- U.S. Department of Education (ED) is the cognizant agency for all State education agencies (SEA)
- ED requires each SEA to negotiate an indirect cost methodology for any LEA under its jurisdiction that requests one
- Therefore, SEA is the cognizant agency for each LEA under its jurisdiction

Indirect cost rate proposal

- SEA generally distributes an “**indirect cost rate proposal (ICRP)**” form to its LEAs and uses the data collected to develop each LEA’s indirect cost rate
- ICRP is a schedule documenting the formulation of the LEA’s **indirect cost rate** and **direct cost base** -- it is the LEA’s request for the establishment of an indirect cost methodology

Indirect cost rate agreement

- Once the SEA approves the ICRP, the end result is an **indirect cost rate agreement** between the SEA and the LEA

- Key info from indirect cost rate:
 - ▣ Current and approved indirect cost rate (established for a specific fiscal year); and
 - ▣ Corresponding direct cost base

Why is this information important?

- SFAs need the information in the indirect cost rate agreement and need to understand it correctly
- SFAs shouldn't just be given the indirect cost rate in percentage form! This is not enough. SFA needs 2 key pieces of information, indirect cost rate and corresponding direct cost base, because each is useless without the other!!!
 - ▣ **Indirect cost rate can only be applied to items in the direct cost base**



Determining Direct & Indirect Costs

Overview



- We touched upon this in earlier slides, but now will go into depth on determining direct and indirect costs
- Also, this section will provide some specific examples of cost

Overview, contd.

- The treatment of a cost as direct or indirect is almost always driven by its treatment in the program operator's accounting system
- The indirect cost methodology the SEA prescribes for a school district may call for direct-indirect distinctions
 - ▣ The SFA must defer to such instructions from the SEA, since their authority to issue them is based on Federal regulations issued by the U.S. Department of Education

Overview, contd.

- The SFA is required to treat each item of cost in a **consistent manner** as a direct or indirect cost in accordance with the Federal cost principles
- A cost may be assigned to the nonprofit school food service as a direct cost only if that cost item under the same circumstances has not been charged to other programs or cost objectives as an indirect cost

Overview, contd.

- **Example:** It is appropriate for a SFA that has relocated its school food service and several other of its activities from the main school building to an annex, to charge rent for the annex to the nonprofit school food service account only if the other activities relocated there are similarly charged

Questions to help determine if a cost is direct or indirect

- Does the cost benefit multiple programs or other cost objectives, or solely the school food service?
- Does the cost have a direct relationship to the school food service?
- What guidance do the Federal cost principles provide for this cost?
- How are similar costs treated in other cost objectives of the SFA?
- How has this cost been treated historically by the SFA?

Examples of Cost



- Remember, we provided examples earlier, but those examples focused on determining allowable costs
- The next few examples focus on determining if the cost was properly assigned as a direct or indirect cost

Custodial expenses

- Generally includes the costs of cleaning the entire school

- **Some SFAs charge custodial expenses directly:**
 - ▣ SFAs document the hours that custodians work cleaning food service areas through a time reporting system
 - ▣ Time reporting system provides the exact hours a custodian cleans the food service area and the rest of the school
 - ▣ The SFA then charges the custodial expenses for cleaning the school food service area as a direct expense

Custodial expenses, contd.

- **Some SFAs charge custodial expenses indirectly** by including them in the indirect cost pool if a methodology or process for determining this item's direct relation to the school food service operations is not available
- **Note:** Custodial expenses may be charged as a direct or indirect cost, **as long as it is treated consistently in all activities of the SFA.** An SFA may not charge custodial expenses as a direct cost to the school food service (e.g., through a time reporting system) and as an indirect cost for other programs

Post-retirement healthcare benefits

- Indirect cost methodology applied to an SFA may call for allocating the cost of providing health-care benefits for retired SFA employees on the basis of numbers of employees
- This may not be fair if school food service workforce is atypical of the SFA's general workforce

Post-retirement healthcare benefits, contd.

- Result maybe overcharging the school food service if part-time employees, who are not eligible for post-retirement health-care benefits, comprise a disproportionate share of the school food service staff
- The amount charged to the school food service for post-employment health-care costs would then be unreasonable based on the benefit the school food service received from this cost item

Post-retirement healthcare benefits, contd.

□ Possible remedies:

- Changing the allocation basis for this cost item from “number of employees” to “number of full-time employees”
- Shifting the SFA’s overall indirect cost methodology to the multiple allocation base method



Considerations – Assessing Charges

Indirect cost charges

- Indirect costs such as utility bills, janitorial services, trash services, etc., are often paid from the school district's general fund and then generally billed to the nonprofit school food service account
- Remember, SFAs are reimbursed under the meals-times-rate funding model, but direct and indirect costs associated with delivering the program are billed (or charged) to the nonprofit school food service account

Indirect cost charges, contd.

- No matter how seemingly appropriate a cost appears to be (i.e., utilities, trash collection, janitorial services, etc.), costs may be **billed** to the nonprofit school food service account only with **appropriate documentation**

How does the school district recover indirect costs?

- Does the school district have to bill the school food service for indirect costs?
- No, a school district generally has two options to recover the indirect costs benefiting the school food service, yet paid from the general fund:
 - ▣ Directing the general fund to rely on its own allotments, or
 - ▣ Billing the school food service

How does the school district bill food service for indirect costs?

- The general fund often bills the school food service for its share of the indirect costs by applying the State-approved indirect cost rate to the school food service's direct cost base
- The billed amount generated is the amount of indirect costs properly allocable to the school food service (**as long as there are no errors, more on this later**)

SFA must not overpay!

- School food service is not allowed to pay **any amount in excess of the properly billed indirect costs** (the portion of costs that do not support the operation or improvement of the food service) with funds from the nonprofit school food serviced account

How to avoid incorrect indirect cost charges?

- Errors can occur for a variety of reasons:
 - ▣ Mathematical error
 - ▣ User assessment
- Stewards of the nonprofit school food service account must be provided the necessary tools to verify and validate costs when necessary

SFA needs the necessary tools

- Compare the approved indirect cost rate proposal (ICRP) and the approved indirect cost rate agreement
- Remember this can only be done if the SFA is provided this information from the SEA. These are the necessary tools the SFA needs!

SFA needs the necessary tools, contd.

- If the approved indirect cost rate and direct cost base are used, the SFA should compute the amount of indirect costs chargeable to the school food service and compare this result with the actual amount of indirect costs billed to the school food service to ensure no mathematical errors have occurred



For example, if you hire a contractor to build you a deck, it makes sense to review the original estimate she gave you with the actual invoice!

Review ICRP/indirect cost rate agreement

- Alert to following areas during review:
 - ▣ Use of an unapproved rate or methodology;
 - ▣ The allowability of the indirect costs included in the indirect cost pool;
 - ▣ The inclusion of the same cost in both the indirect cost pool and direct cost base;
 - ▣ Treating a cost inconsistently (i.e., in some cases the cost is direct and in others the same cost is indirect);
 - ▣ Using undocumented costs in the indirect cost pool or direct cost base;
 - ▣ The composition of the direct cost base (i.e., is the base stable and consistent); and,
 - ▣ The mathematical accuracy of the computation of the indirect cost rate

Review recent audits

- SFA should review recent audits of the school district to determine if problems have been identified in the LEA's prior indirect cost rate calculations

Retroactive Billing

- Many school districts have never billed indirect costs to the nonprofit school food service account, because the general fund contained enough funds to cover such costs and they wanted to support school food service
- There is no Federal requirement that prohibits an SFA from changing its internal fiscal policy regarding the recovery of indirect costs (i.e., originally chose to absorb all indirect costs and then later felt it couldn't keep paying for indirect costs out of general fund)

Retroactive Billing, contd.

- **It is unallowable to bill the nonprofit school food service account for indirect costs that were paid from the general fund in prior years unless an agreement exists to show that the district had been “loaning” the nonprofit school food service account funds to cover the indirect costs in one or more prior years**
- Proper documentation needed -- an official “inter-fund” transaction had been posted to the accounting records of the general fund and the school food service each year that such a “loan” had been made

Restricted vs. Unrestricted Rates

- Unrestricted Rate (negotiated rate):
 - Emerges from an LEA's ICRP calculations
 - This rate is known as a **negotiated or unrestricted rate because it is not limited by Federal restrictions** and allows an LEA to recover the full cost of its Federal programs

Restricted vs. Unrestricted Rates, contd.

□ Restricted Rate:

- Formula generates a lower restricted rate
- The LEA must use the restricted rate to determine indirect costs allocable to those Federal educational programs whose authorizing statutes include the supplement-not-supplant language (prevents an LEA from recovering the full cost of those programs from the State)
- The LEA must absorb, from its own resources, the difference between indirect costs allocable to those programs under the restricted rate, and what those costs would have been if determined via the unrestricted rate

Restricted vs. Unrestricted Rates, contd.

- **The legislation authorizing the SMPs does not contain a “supplement-not-supplant” requirement; therefore, the school district may bill the school food service at the unrestricted rate**
- Some LEAs have nevertheless opted to support the food service by billing at the restricted rate, which is lower (the LEA must apply the selected rate consistently throughout that period)

Error found?

- ❑ **Steps an SFA should take if indirect costs charged to the nonprofit school food service account result from mathematical error or user assessment:**
 - ▣ The appropriate officials should be notified and the ICRP and indirect cost methodology corrected as soon as possible;
 - ▣ If there is a disagreement between the SFA and the appropriate officials, the SA or SEA should be contacted to discuss the issue; and

Error found, contd.

- ▣ The SFA should not pay for any costs resulting from the mathematical error or user assessment until the issue has been appropriately remedied

Note: The SA or SEA should seek FNS' guidance, if needed, by contacting the appropriate FNS Regional Office



Questions?